Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DAL:1:POSTF-106370-02
JSRepsis

date: March 27, 2002

to: Zeke Taylor, Team Manager, LMSB Group 1391

from: Area Counsel, Large and Midsize Business (Natural Resources)

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subject: [redacted]
EIN [redacted]

Tax Years: [redacted] and [redacted]

UIL: 6501.00-00; 6229.00-00; 1311.00-00

This memorandum responds to your oral request for assistance on March 25, 2002. This memorandum should not be cited as precedent.

You have requested that our office provide advice on the two issues stated below. Expedited treatment has been requested since the Appeals Office assigned this case plans to take action within the next two weeks on scheduling the final assessment on this taxpayer for its [redacted] and [redacted] tax years.

Issues

1. In these particular circumstances, does a Form 872 extend the statute of limitations for partnership items that have been converted to nonpartnership items due a settlement of the underlying partnership issues?

2. In these particular circumstances, does the statute of mitigation under I.R.C. §§ 1311-1314 hold open the statute of limitations for [redacted] and [redacted] such that an assessment may be made for intangible drilling costs that would otherwise be deducted again in [redacted]?

Short Answer

1. In these particular circumstances, we believe that a persuasive legal argument can be made that Form 872 does extend the statute of limitations under § 6229(f) for partnership items

that have been converted to nonpartnership items due to a settlement of the underlying partnership issues.

2. In these particular circumstance, we do not believe that the statute of mitigation under I.R.C. §§ 1311-1314 holds open the statute of limitations for [redacted] and [redacted].

Factual Analysis

Although you have supplied us with many of the pertinent facts, we have not had the opportunity to review any of the underlying documents for this matter. If any of the facts contained in this analysis prove incorrect, then our analysis will, in all likelihood, change.

[redacted] (taxpayer) is a corporation that files its tax returns (Form 1120 - U.S. Corporation Income Tax Return) on a calendar year basis. It is currently being examined for its [redacted], [redacted], [redacted] and [redacted] tax years. You have provided us with no information regarding the filing of the [redacted], [redacted] and [redacted] tax returns(Forms 1120). The [redacted] tax return (Form 1120)was received by the Service on September 15, [redacted]. The statute of limitations for both years were extended together by a series of consents to extend the statute of limitations (Form 872 - Consent to Extend the Time to Assess Tax). The first and second Forms 872 extended the statute of limitations to [redacted] and [redacted], respectively. As you have not provided us with these forms, we will assume that they have been properly executed by the parties.

A third consent was solicited from the taxpayer to extend the statute of limitations until [redacted]. The consent was signed by the taxpayer on [redacted] and countersigned by the Service on [redacted].

The taxpayer was a [redacted]% partner in the [redacted] for [redacted], [redacted], [redacted] and [redacted]. The partnership is an oil and gas production partnership which files its Form 1065 (U.S. Partnership Return) on a calendar year basis. The other partners in the partnership are also major oil and gas companies. The partnership is subject to the TEFRA unified audit procedures for its [redacted] and [redacted] tax years. For [redacted] and [redacted], the partnership falls under the "small partnership" exception of I.R.C. § 6231(a)(1)(B) and is not subject to TEFRA.

The partnership is currently under audit by the Service in California. Adjustments were proposed to partnership items for [redacted], [redacted], [redacted] and [redacted]. As we understand it, one of the major

adjustments was to intangible drilling costs (IDCs) for [redacted]. The tax year [redacted] had no adjustments which resulted in any tax liability for the taxpayer.

In [redacted], the partnership deducted IDCs of approximately $[redacted]. The Service proposed to capitalize approximately $[redacted] of these costs. Under this adjustment, the taxpayer will be allowed to start depreciating these costs in [redacted]. Accordingly, a tax benefit will result to the taxpayer in that year. The taxpayer's share of the IDCs disallowance is approximately $[redacted] in [redacted].

The partnership agreed to all of the adjustments proposed by the Service for [redacted] and [redacted]. To effectuate the settlement, all of the partners signed separate Forms 870-P (Agreement to Assessment and Collection of Deficiency in Tax for Partnership Adjustments). The taxpayer, as a partner in the partnership, signed a Form 870-P agreeing to the adjustments on [redacted]. The Service countersigned this agreement on [redacted]. After execution of the Forms 870-P by the partners, no other adjustments to the partnership remained outstanding for [redacted] and [redacted]. We have assumed that the Service had in place a Form 872-P (Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership) which held the statute of limitations open to allow the timely execution of the Forms 870-P.

The partnership also agreed to all of the adjustments proposed by the Service for [redacted] and [redacted]. Included in the adjustments for [redacted] is the increase in depreciate attributable to capitalized IDCs for [redacted]. To effectuate the settlement, all of the partners again signed separate Forms 870-P. The taxpayer, as a partner in the partnership, signed a Form 870-P agreeing to the adjustments on [redacted]. The Service countersigned this agreement on [redacted]. After execution of the Forms 870-P by the partners, no other adjustments to the partnership remained outstanding.

It is now agreed that the signing of the Forms 870-P was incorrect for [redacted] and [redacted]. Since the partnership was not subject to TEFRA for [redacted] and [redacted], adjustments to the partnership items had to be made directly to the partners' separate tax returns.

The agent in charge of the taxpayer's examination for [redacted], [redacted], [redacted] and [redacted] received the Forms 870-P for the taxpayer, as a partner in the partnership, shortly after they were executed. The agent placed the Forms 870-P in the administrative file. No assessment was made of the amounts agreed to on the Forms 870-P. No consent to extend the statute of limitations was solicited

from the taxpayer for the amounts shown on the Forms 870-P.

In the Spring of [redacted], the examination of the taxpayer's [redacted] and [redacted] tax years was concluded. An agreement could not be reached on all issues and the case was forwarded to the Appeals Division in Houston, Texas. In his review of the file, the Appeals Officer came across the [redacted] and [redacted] Form 870-P for the taxpayer. Pursuant to I.R.C. § 6229(f), the Appeals Officer has questioned whether the statute of limitations remains open to allow the Service to assess the amounts shown on this Form 870-P for the partnership.

Legal Analysis

1. In these particular circumstances, does a Form 872 extend the statute of limitations for partnership items that have been converted to nonpartnership items due a settlement of the underlying partnership issues?

Settlement and Conversion of Partnership Items

For tax years ending before August 6, 1997, Form 870-P is used to settle partnership items at the partnership level. Partnership items become nonpartnership items for a particular partner as of the date the Service and the partner enter into a settlement agreement with respect to such items. § 6231(b)(1)(C).

Section 6230(a)(2)(ii) provides that the deficiency procedures do not apply to partnership items which were converted because of a settlement agreement. Accordingly, when partnership items become nonpartnership items by reason of a settlement agreement, the TEFRA partnership audit provisions continue to apply for purposes of assessment or collection of any computational adjustment. In other situations where items become nonpartnership items, the tax treatment is determined under the regular audit, deficiency and refund procedures instead of the TEFRA partnership procedures. See I.R.C. §§ 6230(a)(2) and 6231(b). Statutory notices of deficiency need not be issued prior to an assessment in accordance with a settlement agreement. § 6230(a)(2)(A).

Statute of Limitations for Converted Items

Section 6229(f) provides that upon conversion of the partnership items to nonpartnership items, the period for assessing any income tax attributable to such items shall not expire before the date which is one year after the date on which

the items become nonpartnership items. This provision explicitly provides for extensions of the one-year period as follows:

> ... The period described in the preceding sentence (including any extension period under this sentence) may be extended with respect to any partner by agreement entered into by the Secretary and such partner. § 6229(f)(1)

Normally the one-year statute can be extended by Form 872-F (Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership That Have Converted Under Section 6231(b) of the Internal Revenue Code) which is specifically designed for this situation.

In the case at hand, the Form 870-P was signed by the Service on [redacted]. As of that date the partnership items converted to nonpartnership items. Under § 6229(f)(1), the Service had until [redacted] to assess, unless the one-year period was extended.

Subsequent to the conversion to nonpartnership items, but prior to the expiration of the one-year period, the taxpayer signed a new consent to extend the statute of limitations on nonpartnership items by means of Form 872. This consent was signed on [redacted] by the taxpayer and countersigned on [redacted] by the Service. This consent extended the statute of limitations for all nonpartnership until [redacted].

Does the Form 872 extend the statute of limitations for converted partnership items?

Section 6229(f)(1) is clear that the statute of limitations for converted items can be extended. The manner in which the statute can be extended is not specifically addressed in the statute. We believe this is significant.

Section 6229 deals with the period of limitations for making assessments under TEFRA. Generally, the period for assessing any tax attributable to partnership items with respect to any partner will not expire before three years from the later of: the due date of the partnership's return (without regard to extensions) or the date the partnership's return is filed. § 6229(a).

After Rhone-Poulenc Surfactants and Specialties, L.P., GAF Chemicals Corporation, A Partner Other Than The Tax Matters Partner v. Commissioner, 114 T.C. 533 (2000), it is clear that section 6229 is an extension of the statute found in section 6501 for a partner in a partnership. Thus, when questioning whether

the statute of limitations is open, the primary focus should be under § 6501 as extended under § 6229.

In addition to the partnership, a partner may also extend his partnership items for himself. Under section 6229(b)(1)(A), a partner may extend his partnership items solely for himself if the consent specifically states that these items are being extended. See § 6229(b)(3). Absent the use of this special language, only the statute of limitations for nonpartnership items will be extended with a Form 872.

Notably absent from the provision of § 6229(f)(1) to extend converted items is the requirement for special language as found under § 6229(b)(3). We believe that this omission was not an overcite on the part of Congress. Rather, it was an indication that once a partnership item converted to a nonpartnership item, then the statute of limitations under § 6501 governs. As such, a consent executed under § 6501(c)(4) subsequent to the conversion would extend the converted items as well as those items which were always nonpartnership items.

We believe it is important that the Form 872 consent was executed subsequent to the conversion and prior to the statute of limitations under § 6229(f) expiring. Such a consent would indicate the taxpayer's intent to extend all nonpartnership items (of which the converted items were a part) and there was still a statute to extend under § 6229(f)(for the converted items).

We also note that this approach alleviates the problem of a return which reports a loss both before and after converted items are taken into account, yet might still be subject to a deficiency determination. Since a loss exists before and after the converted items are taken into account, no deficiency could be determined which would give rise to an assessment. If only an expired one-year statute applied and a deficiency was determined subsequent to the expiration, then no tax could be assessed based upon the converted item. On the other hand, if the statute for assessment of the converted item was tied to the statute under § 6501, then a tax could be assessed so long as this statute under § 6501 was in some fashion still open (i.e., consent, 25% omission, etc.).

Although we think it is always preferable in the future to extend the statute under § 6229(f) using Form 872-F, we believe that a persuasive argument exists that the statute for assessment of the converted item is extended by the consent under § 6501(c)(4) in this case (i.e., the Form 872 executed on [redacted]. In all future cases, please ensure that a Form 872-F has been secured from the taxpayer for converted partnership

items under TEFRA.

2. In these particular circumstances, does the statute of mitigation under I.R.C. §§ 1311-1314 hold open the statute of limitations for [redacted] and [redacted] such that an assessment may be made for intangible drilling costs that would otherwise be deducted again in [redacted]?

The Statute of Mitigation

The mitigation provisions of sections 1311 - 1314 of the Internal Revenue Code (sometimes referred to as the "statute of mitigation") were designed to palliate the effect of the statute of limitations in certain meticulously and narrowly drawn situations. See Bradford v. Commissioner, 34 T.C. 1051, 1054 (1960). For an adjustment to be authorized under these provisions, four conditions must be met:

- First, an error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law. See I.R.C. §1311(a).

- Second, there must be a "determination" for an open tax year. As defined in section 1313(a) , a "determination" is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treas. Reg. §1.1313(a)-4.

- Third, the determination must result in a circumstance under which an adjustment is authorized by section 1312 .

  There are seven circumstances under which an adjustment is authorized: double inclusion of an item of gross income (section 1312(1)); double allowance of a deduction or credit (section 1312(2)); double exclusion of an item of gross income (section 1312(3)); double disallowance of a deduction or credit (section 1312(4)); correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (section 1312(5)); correlative deductions and credits for certain related corporations (section 1312(6)); and basis of property after erroneous treatment of a prior transaction (section 1312(7)).

- Fourth, except for determinations described in section 1312(3)(B) and in section 1312(4), the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred. See I.R.C. §1311(b).

Once all four of the conditions for mitigation have been met, an adjustment will be authorized for the closed year in the amount and by the method described in section 1314.

In determining whether the provisions of sections 1311 -1314 apply, it is necessary to review each requirement separately. Failure to meet one of the provisions will make the statute of mitigation inapplicable.

Does the Statute of Mitigation apply to the capitalized intangible drilling costs?

In this particular case, the Service has determined that certain IDCs which were deducted by the partnership in [redacted] should be capitalized with depreciation for the items being allowed starting in [redacted]. As we understand it, the delay in allowing depreciation is caused by the asset not having been placed-in-service until that year.

Assuming it is ultimately decided that the statute of limitations is not open as discussed in Issue #1, then the [redacted] tax year is closed to adjustment for the converted item. The first requirement of the statute of mitigation has been met.

For the second requirement to have been met, a "determination" has to have been made in an open year regarding the correct treatment of an item on a taxpayer's return. This determination would result in an adjustment to one of items in the third requirement. In other words, there has to be a determination made in [redacted] that the IDC should be capitalized and depreciated starting in that year.

As previously stated, a determination under this requirement must be one of the following:

(1) a final decision by the U.S. Tax Court or a final judgment, decree, or other order by any court of competent jurisdiction;

(2) a closing agreement;

(3) a final disposition by the IRS of a claim for refund; or

(4) certain informal agreements between the IRS and the taxpayer or a person acting for the taxpayer, as described in Treas. Reg. §1.1313(a)-4.

See: Treas. Reg. §§ 1.1313(a)-1, 2,3 and 4.

Since the partnership items for [redacted] and [redacted] are not governed by TEFRA, they are still subject to adjustment as the examination of the taxpayer for these years is not closed. Since such a determination has not been entered into, this requirement has not met.

Could it be argued that the Form 870-P for [redacted] and [redacted] is a determination for purposes of the second requirement? For the Form 870-P to be a determination, it would have to fall under Treas. Reg. § 1.1313-4 as an informal agreement.
In general, an informal agreement must contain a statement setting forth the amount of tax determined for the open tax year to which the agreement relates; a statement of the material facts with respect to the item of income, deduction, or credit that was erroneously treated in the closed tax year and how such item was treated in computing the tax of the open tax year; a statement of the amount of the adjustment, as determined under Code Sec. 1314, for the tax year in which the error was made and other applicable tax years; and a waiver of restrictions on assessment and collection of any deficiencies for the tax year of error and other affected tax years. Treas. Reg. §1.1313(a)-4(b). Form 2259 (Agreement as a Determination Pursuant to Section 1313(a)(4) of the Internal Revenue Code)is specifically designed to meet the requirements of this section.

Although the Form 870-P does meet some of the requirements under Treas. Reg. §1.1313(a)-4(b), it does not meet all of them. Specifically, it does not provide a statement of the material facts with respect to the item of income, deduction, or credit that was erroneously treated in the closed tax year and how such item was treated in computing the tax of the open tax year and a statement of the amount of the adjustment, as determined under Code Sec. 1314, for the tax year in which the error was made and other applicable tax years. Consequently, again, we do not believe that the second requirement has been met.

By the Form 870-P for [redacted] and [redacted], the taxpayer has indicated an agreement to the depreciation on the capitalized IDCs. This agreement would constitute a double deduction since the taxpayer would be deducting the IDCs once in [redacted] and again, as depreciation, in [redacted]. The third requirement has been met.

Finally, the determination must adopt a position maintained by a party that is inconsistent with the error that has occurred. The type of inconsistent position referred to in the statute is illustrated by the example under Treas. Reg. §1.1311(b)-1(c)(1):

> A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the

> taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

As the example under Treas. Reg. §1.1311(b)-1(c)(2) illustrates, for an adjustment to be made in the government's favor, the taxpayer, rather than the government, must have taken an inconsistent position for another tax period:

> In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

In accord FSA 200133004.

In present case, the taxpayer has maintained a consistent position by deducting the IDCs in [redacted] and not capitalizing them and deducting them again in [redacted]. Through its partnership adjustments, the Service is forcing the taxpayer into an inconsistent position by arguing that its partnership adjustments cannot not be made in [redacted] (due to a barred statute), but should be allowed as depreciation in [redacted]. Accordingly, the fourth requirement of the statute of mitigation has also not been met.

Based upon the above analysis, we have concluded that application of the statute of mitigation is not warranted in this situation. Two of the four requirements have not been met. Consequently, an assessment of the any tax due from the partnership adjustments for the [redacted] tax year can not be made pursuant to the statute of mitigation.

Conclusion

We wish that we were afforded more time to consider the issues which you requested we provide advice on. Other alternatives may exist, but have not yet been considered. Given the circumstances, we believe that a persuasive legal argument exists that the statute of limitation for the [redacted] and [redacted] tax years is being held open by the Form 872 executed by the taxpayer for [redacted] and [redacted] on [redacted]. We do not believe that the statute of mitigation, by itself, allows assessment for the [redacted] and [redacted] tax years.

This document is subject to the Large Case Coordination Procedures of CCDM 35(19)4(4). Pursuant to this provision, a copy of this advice has been forwarded to the Associate Chief Counsel for his review concurrent with the providing of this advice to you. Within ten days of receipt, the appropriate Associate Chief Counsel is required to respond regarding the advice. The response will indicate whether the National Office: (a) concurs with the field advice; (b) believes some modification of the advice is appropriate; or (c) needs additional information or time for analysis in order to evaluate the advice. Our office will inform you of the comments received by us.

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Our office will maintain its file on this case pending notification from you that it may be closed. If you should have any questions regarding this memorandum, please contact the undersigned at (972) 308-7917.

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By:_____
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